July 14, 2008

Op-Ed Columnist

Fannie, Freddie and You

NEW YORK TIMES

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And now we’ve reached the next stage of our seemingly never-ending financial crisis. This time Fannie Mae and Freddie Mac are in the headlines, with dire warnings of imminent collapse. How worried should we be?

Well, I’m going to take a contrarian position: the storm over these particular lenders is overblown. Fannie and Freddie probably will need a government rescue. But since it’s already clear that that rescue will take place, their problems won’t take down the economy.

Furthermore, while Fannie and Freddie are problematic institutions, they aren’t responsible for the mess we’re in.

Here’s the background: Fannie Mae — the Federal National Mortgage Association — was created in the 1930s to facilitate homeownership by buying mortgages from banks, freeing up cash that could be used to make new loans. Fannie and Freddie Mac, which does pretty much the same thing, now finance most of the home loans being made in America.

The case against Fannie and Freddie begins with their peculiar status: although they’re private companies with stockholders and profits, they’re “government-sponsored enterprises” established by federal law, which means that they receive special privileges.

The most important of these privileges is implicit: it’s the belief of investors that if Fannie and Freddie are threatened with failure, the federal government will come to their rescue.

This implicit guarantee means that profits are privatized but losses are socialized. If Fannie and Freddie do well, their stockholders reap the benefits, but if things go badly, Washington picks up the tab. Heads they win, tails we lose.

Such one-way bets can encourage the taking of bad risks, because the downside is someone else’s problem. The classic example of how this can happen is the savings-and-loan crisis of the 1980s: S.& L. owners offered high interest rates to attract lots of federally insured deposits, then essentially gambled with the money. When many of their bets went bad, the feds ended up holding the bag. The eventual cleanup cost taxpayers more than $100 billion.

But here’s the thing: Fannie and Freddie had nothing to do with the explosion of high-risk lending a few years ago, an explosion that dwarfed the S.& L. fiasco. In fact, Fannie and Freddie, after growing rapidly in the 1990s, largely faded from the scene during the height of the housing bubble.

Partly that’s because regulators, responding to accounting scandals at the companies, placed temporary restraints on both Fannie and Freddie that curtailed their lending just as housing prices were really taking off. Also, they didn't do any subprime lending, because they can't: the definition of a subprime loan is precisely a loan that doesn't meet the requirement, imposed by law, that Fannie and Freddie buy only mortgages issued to borrowers who made substantial down payments and carefully documented their income.

So whatever bad incentives the implicit federal guarantee creates have been offset by the fact that Fannie and Freddie were and are tightly regulated with regard to the risks they can take. You could say that the Fannie-Freddie experience shows that regulation works.

In that case, however, how did they end up in trouble?

Part of the answer is the sheer scale of the housing bubble, and the size of the price declines taking place now that the bubble has burst. In Los Angeles, Miami and other places, anyone who borrowed to buy a house at the peak of the market probably has negative equity at this point, even if he or she originally put 20 percent down. The result is a rising rate of delinquency even on loans that meet Fannie-Freddie guidelines.

Also, Fannie and Freddie, while tightly regulated in terms of their lending, haven't been required to put up enough capital — that is, money raised by selling stock rather than borrowing. This means that even a small decline in the value of their assets can leave them underwater, owing more than they own.

And yes, there is a real political scandal here: there have been repeated warnings that Fannie's and Freddie's thin capitalization posed risks to taxpayers, but the companies' management bought off the political process, systematically hiring influential figures from both parties. While they were ugly, however, Fannie's and Freddie's political machinations didn't play a significant role in causing our current problems.

Still, isn't it shocking that taxpayers may end up having to rescue these institutions? Not really. We're going through a major financial crisis — and such crises almost always end with some kind of taxpayer bailout for the banking system.

And let's be clear: Fannie and Freddie can't be allowed to fail. With the collapse of subprime lending, they're now more central than ever to the housing market, and the economy as a whole.